

Changes in Exogenous Costs

	Market Cost Changes				AT&T-Specific Cost Changes				
	Tax	COCOT	ADA-TRS	OBRA (loss)	Depreciation	COMSAT	FAS 106	FAS 112	Asset Write Down
18-Dec-89					(\$141.4)				
28-Jan-90	(\$1.4)				\$0.6				
18-Dec-90	\$0.5								
17-May-91	\$30.8								
28-Jan-91						(\$39.7)			
19-Dec-91					(\$24.8)				
15-May-92	\$72.9	\$10.4			(\$0.4)	\$26.9			
30-Jan-92	(\$2.7)								
17-May-93	\$38.1								
30-Jan-93							\$242.9		
17-Dec-94			\$11.5						
17-May-94	\$9.7	\$3.6	(\$1.5)	\$3.2	\$0.6		-81	231.1	
30-Jan-94				(\$3.2)	(\$1.2)			-231.1	
01-Aug-94								208.7	
11-Aug-94									-12
18-Nov-94								-27	
19-Dec-94				\$7.8					
Total	\$147.9	\$14.0	\$10.0	\$7.8	(\$166.6)	(\$12.8)	\$161.9	\$269.7	(\$12.0)
1/91 - 12/94	\$148.8	\$14.0	\$10.0	\$7.8	(\$25.8)	(\$12.8)	\$161.9	\$269.7	(\$12.0)

Market 89-94	\$171.9	Market 91-94	\$180.8
AT&T-specific	\$240.2	AT&T-specific	\$361.0
Total	\$412.1	Total	\$541.6

ATTACHMENT 2

Before the
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of

Policy and Rules Concerning
Rates for Competitive Common
Carrier Services and Facilities
Authorization Therefor

CC Docket No. 79-252

**FURTHER OPPOSITION OF BELL ATLANTIC CORPORATION,
BELLSOUTH CORPORATION, PACIFIC TELESIS GROUP, AND
SBC COMMUNICATIONS INC. TO AT&T'S MOTION FOR
RECLASSIFICATION AS A NONDOMINANT CARRIER**

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SUMMARY

AT&T's claims of healthy competition were baseless when made in 1993, as Bell Atlantic, BellSouth, Pacific Telesis, and SBC showed.* Now, more than a year and a half later, the only thing that has changed is that additional evidence proves the error of AT&T's arguments.

While AT&T defends its motion on the basis of erroneous economic theory, the actual pricing of long distance services conclusively shows that AT&T retains market power. As expert affidavits and economic studies appended to this Further Opposition demonstrate, the price/cost margins of long distance services are high and climbing, contrary to what would be seen in a competitive market. AT&T continues to deny consumers the benefit of LEC access charge reductions and other savings AT&T realizes from network efficiencies. MCI and Sprint follow AT&T's price increases even though their own costs are falling, further showing AT&T's price leadership. Nor do "discount plans" inject competition into the interexchange business, since discounted rates are unavailable to many callers and, even when available, simply offset increases in basic rates.

The answer to AT&T's complaints about excessive regulation is an open, competitive long distance market. AT&T, however, continues to impede interexchange competition by opposing removal of MFJ restrictions on the seven Bell companies, who are its most

*See Opposition to the Motion of American Telephone & Telegraph Company for Reclassification as a Nondominant Carrier, CC Docket No. 79-252 (FCC filed Nov. 12, 1993).

natural competitors. The Commission should continue to support the advent of competition in long distance, and reject AT&T's repetitive requests for reclassification until that goal is accomplished.

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When filed in 1993, AT&T's request to be reclassified as a nondominant carrier flew in the face of economic reality. Nearly ten years after divestiture, the major players in the interexchange market had established a cooperative pricing pattern in which MCI and Sprint followed AT&T's lead. In its recent presentation to the Commission, AT&T seeks to revitalize its request for reclassification.¹ That request is even less well-founded than the original petition.

AT&T rests its renewed request largely on arguments about the structure of long distance markets. These arguments are insufficient in their own right, but, more importantly, they ignore actual market performance. The best evidence of the state of competition in the interexchange business, and the clearest evidence

¹Ex Parte Presentation in Support of AT&T's Motion for Reclassification as a Nondominant Carrier, CC Dkt. No. 79-252 (FCC Apr. 20, 1995) ("AT&T Presentation").

of AT&T's continued ability to wield market power, is real-world pricing. On that score, the evidence is overwhelming that AT&T has not joined in competitive battle with its lesser rivals, but rather has set prices increasingly above cost, both by raising rates and by failing to give consumers the benefit of cost reductions.

The one feasible solution to the lack of competition in interexchange services is allowing the only natural new competitors -- the seven Bell Companies -- to compete. Legislative and legal initiatives that would achieve that result are underway, over AT&T's opposition. Until these initiatives have run their course, deregulation of AT&T would be both premature and unwise.

I. AT&T'S EVIDENCE OF ALLEGED COMPETITION IS DEFECTIVE

Citing the emergence of hundreds of small interexchange resellers and the deployment of massive fiber-optic capacity, AT&T argues that it cannot charge supracompetitive prices because "there are no barriers to entry into the long distance business." AT&T Presentation at 18; see id. at 13-30.

AT&T's claim that there are no barriers to entering the interexchange market is at odds with an elemental market fact: More than a decade after divestiture, AT&T, MCI, and Sprint are still the only national, facilities-based carriers. See Reply Affidavit of Professor Jerry A. Hausman at 4 ("Hausman Reply Aff."), appended hereto. Indeed, the absurdity of AT&T's position is highlighted by AT&T's ongoing effort to manufacture a fourth major carrier to support its regulatory positions. In a 1987 report prepared for AT&T, Professor Michael Porter named Western Union as the fourth

interexchange carrier.² In 1990, Professor Porter named National Telecommunications Network (NTN).³ In this proceeding, the "fourth carrier" du jour is the combined LDDS/Wiltel (AT&T Presentation at 7, 16, 23), which has deployed less than 1 percent as much fiber as AT&T since 1990, and generates about 4 percent as much annual revenue.⁴

Nor are there any serious new players on the horizon. Almost all of the "hundreds of IXC rivals" cited by AT&T (AT&T Presentation at 2) are minor resellers who have no interexchange facilities to speak of, but are limited to arbitraging the gap between the wholesale and retail prices set by AT&T, MCI, and Sprint. They cannot undercut the wholesale prices set by the major carriers or offer higher-quality service than what is available from their suppliers, and thus remain vulnerable to AT&T's ongoing anticompetitive practices. See, e.g., Public Serv. Enter. of Pennsylvania, Inc. v. AT&T Corp., Dkt. No. 95-169 (FCC adopted Apr. 20, 1995) (finding violations of 47 U.S.C. § 201 and Commission resale rules); AT&T Communications Apparent Liability for Forfeiture

²See Michael E. Porter, Competition in the Long Distance Telecommunications Market: An Industry Structure Analyses at 8 (1987).

³See Michael E. Porter, Competition in the Long Distance Telecommunications Market: An Industry Structure Analysis at ix (1990).

⁴Jonathan M. Kraushaar, FCC, Industry Analysis Div., Fiber Deployment Update EOY 1993 at Table 2 (May, 1994); Standard & Poor's Profiles and Earnings Estimates Database, May 19, 1995. AT&T's own exhibits show that the LDDS and Wiltel networks are comprised largely of leased facilities. See Attachment C to AT&T Presentation.

and Order to Show Cause, 10 FCC Rcd 1664 (1994) (imposing \$1,000,000 fine for "intentional attempt to vitiate the goals of the Commission's resale policy"). See generally Reply Affidavit of Paul W. MacAvoy ¶¶ 18-20 ("MacAvoy Reply Aff."), appended hereto.

With respect to facilities-based competition, AT&T claims that it cannot maintain prices above competitive levels because MCI and Sprint have built vast excess capacity and could absorb AT&T's traffic "at minimal capital cost." AT&T Presentation at 14; see id. at 13-19. Excess capacity does nothing to upset the oligopolistic structure of the long distance market. Fully 57 percent of the "[o]ver 400,000 fiber miles [that] have been constructed between 1990 and 1993" (id. at 15) were constructed by AT&T, and AT&T, MCI, and Sprint together accounted for over 97 percent of all interexchange deployment. FCC Fiber Deployment Update, EOY 1993 at Table 2 (May 1994).

Indeed, the vast capacity and other economic characteristics of today's long distance networks are an obstacle to competition, rather than an assurance of it. Long-haul, fiber-optic transmission is characterized by very high initial cost and rapidly falling average cost as traffic volume increases. The expense of laying a nationwide network is huge, but incremental operating costs are relatively small as compared, for instance, to local service; once a fiber-optic interexchange system is laid, carrying additional signals over it is nearly costless. See Affidavit of Jerry A. Hausman ¶¶ 16, 46-47 ("Hausman Aff"), appended hereto. Because higher volume yields lower average cost, this economy of scale

favours AT&T, augmenting the other advantages AT&T possesses as the largest, richest, and best-established carrier.⁵

Given these AT&T advantages, MCI and Sprint could not hope to win a price war. Yet if MCI and Sprint were driven to bankruptcy, their facilities would remain in place and could be acquired -- probably well below cost -- by a new entrant, leaving AT&T no better off. See Hausman Aff. ¶ 17. AT&T's effort to drive its competitors out of the long distance business also would trigger antitrust scrutiny and perhaps increased regulation of AT&T's pricing, leaving AT&T worse off in that respect as well.

At the same time, the high cost of constructing a fiber-optic network and the low marginal cost of operating one allow AT&T and the other major incumbents to ward off new competitors. Potential entrants who would need to invest hundreds of millions or billions of dollars to build a network from scratch before commencing service are deterred by the prospect that all of the three incumbents credibly can threaten to increase output (and lower prices) in response to a new competitor, rendering entry unprofitable. Hausman Reply Aff. ¶¶ 5-6. The only potential entrants who could enter as facilities-based providers at modest cost, because they already have networks in place, are prohibited from doing so under the MFJ.

⁵The high fixed cost of installing advanced common channel signaling (CCS) systems, for example, favours AT&T, especially since the MFJ bars Bell Companies from delivering signaling information to smaller interexchange carriers across LATA boundaries. See United States v. Western Elec. Co., 969 F.2d 1231, 1234-35 (D.C. Cir. 1992).

Given a choice between engaging in a price war that it could not ultimately win, or sharing the profits incumbents can reap when there is no credible threat of new entry, AT&T understandably has chosen the latter course.⁶ Followed by MCI and Sprint, uses its market power to keep prices and profits up, as recent evidence shows.

II. LONG DISTANCE PRICING DEMONSTRATES THAT THE MARKET IS NOT COMPETITIVE

There is no better evidence of AT&T's market power than the actual pricing of interexchange services. See Affidavit of Paul W. MacAvoy ¶¶ 8-12 ("MacAvoy Aff."), appended hereto; Hausman Reply Aff. ¶ 14 ("price should be the primary focus of how well competition is working in the long distance market"). The ability to set prices above the competitive level on a sustained basis is the essence of market power, and AT&T displays precisely this ability. See Hausman Aff. ¶ 25; W.E. Taylor & J.D. Zona, National Economic Research Assocs., Inc., An Analysis of the State of Competition in Long-Distance Telephone Markets at 12 n.13 (May 1995) ("Taylor & Zona"), appended hereto.

In a competitive market, entry by new firms and competition by incumbent firms drives prices toward cost. MacAvoy Aff. ¶ 10. Yet the price/cost margins for AT&T, MCI, and Sprint long distance services have been increasing since the late 1980s. See MacAvoy

⁶AT&T's President of Consumer Communications Services was recently quoted as saying that MCI "[i]sn't considered competition: 'Our biggest competitor is ourselves.'" Network Upgrade Completed: AT&T Offers Home Banking, Other Services, in Significant Marketing Shift, Communications Daily, June 7, 1995, at 5.

Aff. ¶¶ 58-85. This trend of rising price/cost margins holds true not only for residential and small business services (see MacAvoy Reply Aff. Fig. Four (MTS service)), but also for WATS and virtual network services used by large business customers. Id. Figs. Five-Ten.

By Dr. Hausman's estimate, long-distance costs fell by about 6 percent per year between 1990 and 1993 due to new technologies and lower equipment prices, over and above access reductions of 12 percent annually. Hausman Reply Aff. ¶ 14. During the same period real long-distance rates stayed steady, after adjusting price increases for inflation. Id. ¶¶ 14-15. The same non-competitive pricing pattern has prevailed throughout the post-divestiture period. Since 1984, AT&T has benefitted from a \$10.4 billion reduction in access charges and industry-specific exogenous costs, but has decreased its prices by only \$8.5 billion, keeping the remaining \$1.9 billion for itself. Taylor & Zona at 16-17.

AT&T continues to pocket savings that would be passed on to customers in a competitive market. In March 1995, the Commission ordered local telephone companies to reduce their access charges by some \$1.2 billion annually, saving AT&T well over \$600 million each year. In response to this multi-year, multi-billion dollar windfall, AT&T has proposed to leave rates as they are. AT&T says that it will pass along \$350 million in savings to selected consumers, by "extending" discounts already offered to users of the

TrueUSA plan.⁷ Aside from being small compared to AT&T's own savings, this discount (which is not a new price cut at all) will expire after a few months, while AT&T will continue to benefit from lower access charges year after year.

In addition to general price levels, the "lock-step" pricing policies of the three major carriers show that cooperation, not competition, is the rule. See MacAvoy Aff. Appendix; Hausman Aff. at ¶¶ 29-39; Hausman Reply Aff. at ¶ 8. Six times between 1991 and 1994, AT&T raised its prices and MCI and Sprint matched the price increase within days. Hausman Reply Aff. at ¶¶ 8, 20. For instance, in December 1994 (some 14 months after AT&T filed its motion for reclassification), AT&T announced that it would raise basic consumer rates by 3.9 percent, and MCI and Sprint responded almost immediately by filing "virtually identical" tariffs with the FCC.⁸ AT&T thus acts as the dominant price leader, setting a price that MCI and Sprint accept in fixing their own output levels. See FCC, OPP Working Paper No. 25, What Makes the Dominant Firm Dominant? at 3-4 (Apr. 1989) (discussing oligopolistic price leadership).

⁷See AT&T to Pass \$350 Million in Savings on to Consumers, Wall Street Journal, May 19, 1995, at B4; Mike Mills, Critics Doubt AT&T Plan to Pass on Lower Rates, Washington Post, May 19, 1995, at F3.

⁸Long-Distance: AT&T to Raise Rates, Edge, Dec. 12, 1994; Digest, Washington Post, Dec. 20, 1994, at C1. Sprint increased its rates by 3.5 percent, and MCI increased its rates by 3.9 percent. Bureau Suspends, Investigates AT&T Rate Hike Proposal, Telecommunications Reports, Dec. 19, 1994, at 35; Notes on the News -- Regulatory and Government Affairs, Telecommunications Reports, Dec. 26, 1994, at 46.

Additional proof of the lack of price competition for interexchange services can be found in the movement of AT&T, MCI, and Sprint stock prices. In a competitive market, a price increase by one competitor would not cause the price of that firm's stock to rise, nor would it affect the stock prices of the firm's rivals, because the price increase could not be sustained unless costs had increased as well. See MacAvoy Aff. ¶ 48. When AT&T announces a rate increase, however, there is a concurrent increase in the stock market valuation of AT&T, MCI, and Sprint. Id. ¶ 49; see MacAvoy Reply Aff. ¶¶ 61-69. The stock market thus views the interexchange market as non-competitive, such that the profits of all three of the major carriers are expected to increase when AT&T announces a price increase. MacAvoy Aff. ¶ 50.

AT&T's competitors have in fact followed along when AT&T raises its prices in response to price-cap adjustments that do not affect MCI's and Sprint's costs. See Hausman Aff. ¶¶ 29-34; Hausman Reply Aff. ¶ 20. In a competitive environment, such a price change by AT&T would cause competitors to undercut AT&T's prices and increase their market share. Hausman Reply Aff. ¶ 6. In the long distance market, however, AT&T's major competitors follow its lead. Such price increases, unrelated to economic cost, further demonstrate AT&T's dominant position in a noncompetitive market.

AT&T's prices are constrained by the Commission's price caps, more than by competition. See Price Cap Performance Review for AT&T, 8 FCC Rcd 5165, at ¶ 17 (1993) (Basket 1 services). Prices at the price cap index would be consistent with competition if the

productivity factor built into price caps matched AT&T's actual productivity. The long-haul, high-capacity nature of AT&T's network, however, allows AT&T to benefit disproportionately from technological productivity gains, and all available evidence indicates that AT&T's actual productivity increases are "substantially higher" than the industry gains assumed by the price cap formula. Hausman Aff. ¶ 27. Under these circumstances, the fact that AT&T's actual prices are consistently close to the price cap maximum further indicates a lack of competition in the provision of interexchange services.

"These fundamental economic facts cannot be explained away." Hausman Reply Aff. ¶ 46. AT&T thus attempts to sidestep them by focusing on its average revenue per minute ("ARPM") for all long distance services, contending that this index has decreased. AT&T Presentation at 32. Examination of AT&T's ARPM provides little insight into the actual prices paid for particular services, because no service is offered or sold at the ARPM "price." MacAvoy Reply Aff. ¶ 49. Moreover, average revenues misrepresent price movements, because they do not account for the introduction of new products, quality changes, or changes in demand for specific products. Taylor & Zona at 20-22; see MacAvoy Reply Aff. ¶¶ 48-50. To illustrate, ARPM might decrease if demand increased faster for lower-cost services than for higher-cost ones, even if the price of all services rose. Likewise, where initial calling minutes are more expensive than subsequent ones, ARPM would fall if the length of the average call increased (which it has since divestiture), even if

prices were constant. Taylor & Zona at 21. AT&T's claims of falling ARPM therefore are nearly meaningless.

Putting aside these methodological shortcomings, AT&T's basic claim is wrong. ARPM can provide a measure of competitive pricing (if at all) only if changes in costs are taken into account. When this is done, ARPM measurements for interstate switched services provide the same indication of increasing profits and parallel pricing as more reliable measurements. MacAvoy Reply Aff. ¶¶ 46-51 & Figure 20; Hausman Reply Aff. ¶ 11; Taylor & Zona at 23-24.

There also is no merit to AT&T's suggestion that "discount plans" targeted to particular residential customers establish the existence of competitive markets. See AT&T Presentation at 24. As a preliminary matter, eligibility for discounted rates is limited. Sixty percent of AT&T's residential customers (39 million in all) have monthly usage levels that are too low to qualify for the plans. MacAvoy Reply Aff. ¶ 28. Only 36 percent of AT&T residential long-distance calls were made using a discount plan, meaning that the other 64 percent of calls were billed at basic rates. Hausman Reply Aff. ¶ 9.

Even for those customers who do qualify for calling plans, "discounts" bring little relief. The reason is simple: Discounts are taken off the tariffed rates, which have been increased to offset any reductions. As the tariffed rates increase, so do the discount rates. General rate increases, in fact, have exceeded new discounts for many plans, so that since 1992 the "discounted" prices available under the plans have been increasing. MacAvoy Reply Aff.

¶¶ 38-41. Price/cost margins for discounted calls are increasing as well, and are virtually the same as the price cost margins for standard MTS service. Id. ¶¶ 42-44. The margins for service under AT&T's Reach Out America plan, for instance, consistently have been 97 or 98 percent of the margins for standard MTS service. Id. Table Six.

Nor does churn among residential customers, or the ad campaigns that prompt it, prove that the interexchange market is competitive. See AT&T Presentation at 33-35. Firms that are not competing on price often shift their efforts to attracting customers through advertising, because increasing price/cost margins make gaining a new customer relatively more profitable.⁹ In such a market, consumers receive little advantage when switching between interexchange carriers; they "are still paying an above competitive price, but from a new long distance carrier." Hausman Reply Aff. ¶ 10.

CONCLUSION

AT&T is right that "customers benefit when the market is driven by competition rather than regulation." AT&T Presentation at 38. But the interexchange market is not competitive today. Indeed, there is every reason to think that AT&T's existing market power will endure as long as the Bell Companies are barred from the long

⁹Oligopolists can be expected to increase their advertising expenditures if price/cost margins rise, or if consumers become more responsive to advertising. MacAvoy Reply Aff. ¶¶ 13-14. AT&T has provided no evidence suggesting that a change in consumer behavior has occurred. Given the evidence of rising price/cost margins, it is reasonable to view increased advertising as a sign of greater profitability, rather than competition.

distance business. The Commission has in the past supported removing MFJ restrictions so that competition can develop.¹⁰ The Commission should hold to that position, and in the meantime deny AT&T's motion.

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¹⁰See, e.g., Reply Comments of the Federal Communications Commission as Amicus Curiae on the Report and Recommendations of the United States Concerning the Line of Business Restrictions Imposed on the Bell Operating Companies by the Modification of Final Judgment at 11, United States v. Western Electric Co., No. 82-0192 (D.D.C. May 22, 1987) (noting that BOC entry into the interexchange market would "enhance, not retard, competition").